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Office of the Chief Economist

September 2005 Economic Outlook

Katrina

The effect of Hurricane Katrina will be felt in the battered Gulf region for quite some time to come. The effect on the national economy has also been quite immediate through lost output from the Gulf region, decline in wage income from workers who have lost their jobs, spike in energy costs, and disruption to import-export trade flows through New Orleans and other near-by ports. The shock to the economy is expected to cut 0.5% to perhaps as much as 0.75% (annual rate) from second-half real GDP growth, reducing economic growth in the latter half of the year to about 3.5%, annualized. The net employment loss will also be substantial, about a 200,000 to 300,000 net shortfall this month directly attributable to the disaster. Thus, the labor market report for September (based on the Labor Department's survey to be conducted the week of September 12), which otherwise would probably have shown a healthy employment gain, will likely show little change or a drop of as much as 100,000 (or more) when it is released on October 7, the first decline in payroll employment since May 2003.

Recovery efforts were slow the first few days but appear to have gained substantial momentum. The federal monies that will go to reconstruction and the lower interest rates that have evolved from the calamity will stimulate economic growth next year. Thus, economic growth is likely to accelerate in the first half of 2006 to make up for the lost economic activity the U.S. will experience over the next few months. A drop in energy costs over the next few months will further support recovery efforts and national growth.

Pre-Katrina, the Federal Reserve had implied that it was likely to continue boosting the federal funds target at quarter-point increments, timed with Federal Open Market Committee (FOMC) meetings. However, it has become more likely that the Fed will take a pause to assess the fragility of the economy and to support the credit needs of recovery efforts. Any pause may well be temporary; with two more FOMC meetings scheduled for the autumn, if the reconstruction efforts are going well we expect the federal funds target may be at 4.0% by year-end.

The weaker near-term growth outlook and greater likelihood of Fed "pause" has brought long-term yields, including mortgage rates, lower once again. It appears likely that 30-year fixed-rate loans will carry interest rates below 6.0% for the balance of the year. Stronger economic activity and additional moves by the Fed to swing monetary policy to a "neutral" stance (that is, further short-term rate hikes in 2006) will push mortgage rates higher in 2006.

While lower near-term mortgage rates will continue to fuel nation-wide housing demand, the reconstruction efforts will place additional upward pressure on construction material costs. The most immediate effects will be on plywood and roofing tiles, as many homeowners make repairs in the broader Gulf region. Since construction materials account for about one-third of the cost of a new home, increases in costs for lumber, cement, gypsum board and other materials of only 5% to 10% could add 2% to 3% to new home costs in coming months, supporting existing home values. The net effect (lower interest rates but higher construction material costs) on overall construction is likely to add to new starts in 2006 and existing home sales, relative to what they would have been. Thus, mortgage originations will be slightly greater too, compared to our pre-Katrina projection.

Details

- *Real GDP growth*. Our forecast for GDP growth was trimmed to 3.5% (annual rate) in both the third and fourth quarters of 2005 to account for the displaced and disrupted economic activity from hurricane Katrina. We increased our forecast for GDP growth in the second and third quarters of 2006 to reflect the boost to future economic activity as the Gulf of Mexico region rebuilds. Oil and other energy prices remain the biggest risk to economic growth.
- *Consumer price inflation*. The impact of Katrina on energy prices should be temporary, as refineries, oil production and pipelines are put back in working order, but high worldwide demand and limited supply will likely keep oil prices above $60 a barrel for a while. Second quarter inflation, as measured by the consumer price index, came in at 4.2% and reflects the recent run-up in oil and gas prices. Inflation will remain elevated in the last few months of 2005 because of the energy-price shock, but then slow in 2006 to about 2.5% as energy costs subside.
- *Unemployment rate*. The unemployment rate for August dipped to 4.9% but the payroll employment new-jobs-added numbers came in short of consensus estimates at 169,000. Looking to September's report, the impacts of the hurricane will be hard to gauge statistically. Many companies will leave workers in the devastated areas on their payrolls until the full extent of the damage is known, the workers are located and the likelihood that the plants or businesses can reopen soon is determined. Although we expect significant volatility in the employment data in the next few months, we've left our unemployment rate forecast unchanged at 5% from third-quarter 2005 through the end of 2006.
- *Mortgage rates*. Bond market reactions to the potential economic impact of Katrina indicate an expectation that the Fed will slow the pace of future interest-rate increases to help the economy recover from the storm's devastation. As a result, long-term yields have fallen and we lowered our forecast for 30-year fixed mortgage rates by about 10 basis points through the first half of 2006.
- *ARM Share.* Lower long-term fixed mortgage rates in our forecast also brought down our forecast for the share of adjustable-rate mortgages. We expect the ARM share to be about 30% through June 2006.
- *Housing starts*. Lower mortgage rates and greatly increased demand for new homes to replace those destroyed in the Gulf of Mexico region will cement 2005's place in the record books for record high housing construction. We boosted our forecast for 2005 housing starts by 2%, to 2.04 million units and by nearly 3% for 2006 starts, to 1.90 million units.
- *Home sales*. Home sales too are set to hit record highs this year, and will be boosted even higher than previously predicted due to lower mortgage rates in the last few months of this year and displaced families seeking new homes. Our forecast calls for 2005 and 2006 single-family house sales to hit 7.32 and 7.07 million units, respectively – this represents an increase of 4% over our previous forecast for 2006 sales.
- *Home value appreciation*. High demand for housing and expected increases in the costs of building materials is keeping pressure on home prices. Second quarter home price growth came in at 15% according to the Conventional Mortgage Home Price Index. Third quarter growth should also be quite strong at about 11.5%, falling off in the fourth quarter to single-digit territory, averaging 7.7% in 2006.
- *Mortgage activity*. Lower expected mortgage rates and higher home sales mean more mortgage originations. We've increased our prediction for total mortgage originations in 2005 to $2.63 trillion with a refinance share of 43%. In 2006, total mortgage originations are expected to decline to $2.52 trillion with a refi share of 35%.

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Office of the Chief Economist

Economic and Housing Market Outlook

September 2025

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Major Economic Indicators

Indicator	2004 Q3	2004 Q4	2005 Q1	2005 Q2	2005 Q3	2005 Q4	2006 Q1	2006 Q2	2006 Q3	2006 Q4	Annual Totals 2001	2002	2003	2004	2005	2006	2007
Real GDP (%)	4.0	3.3	3.8	3.3	3.5	3.5	3.5	3.7	3.7	3.5	0.2	1.9	4.0	3.8	3.5	3.6	3.5
Consumer Prices (%) a.	1.6	3.6	2.4	4.2	3.2	3.2	2.5	2.5	2.5	2.5	1.8	2.2	1.9	3.4	3.3	2.5	2.5
Unemployment Rate (%) b.	5.4	5.4	5.3	5.1	5.0	5.0	5.0	5.0	5.0	5.0	4.8	5.8	6.0	5.5	5.1	5.0	5.0
30-Year Fixed Mtg. Rate (%) b.	5.9	5.7	5.8	5.7	5.8	5.9	6.0	6.1	6.2	6.3	7.0	6.5	5.8	5.8	5.8	6.2	6.5
10-Year Const. Mat. Treas. Rate (%) b.	4.3	4.2	4.3	4.2	4.2	4.3	4.4	4.5	4.6	4.7	5.0	4.6	4.0	4.3	4.2	4.5	4.9
1-Year Const. Mat. Treas. Rate (%) b.	2.1	2.5	3.1	3.3	3.8	4.0	4.1	4.1	4.2	4.3	3.5	2.0	1.2	1.9	3.5	4.2	4.4

Housing and Mortgage Markets

Indicator	2004 Q3	2004 Q4	2005 Q1	2005 Q2	2005 Q3	2005 Q4	2006 Q1	2006 Q2	2006 Q3	2006 Q4	Annual Totals 2001	2002	2003	2004	2005	2006	2007
Housing Starts c.	1.97	1.97	2.08	2.04	2.04	2.00	1.92	1.88	1.90	1.88	1.60	1.70	1.85	1.96	2.04	1.90	1.77
Total Home Sales d.	7.13	7.29	7.23	7.59	7.28	7.16	7.14	7.09	7.04	6.99	5.64	5.95	6.54	7.17	7.32	7.07	6.71
House Price Appreciation (%) e.	17.5	9.8	10.5	15.0	11.5	7.7	7.8	8.3	8.3	6.7	7.5	7.3	8.4	11.2	11.2	7.7	6.8
1-4 Family Mortgage Originations f.																	
Conventional	$659	$650	$568	$674	$700	$598	$534	$637	$668	$581	$1,900	$2,696	$3,629	$2,605	$2,540	$2,420	$2,407
FHA & VA	$30	$23	$21	$21	$29	$22	$22	$27	$28	$24	$167	$187	$231	$129	$93	$101	$100
Total	$689	$673	$589	$695	$729	$620	$556	$664	$696	$605	$2,067	$2,883	$3,860	$2,734	$2,633	$2,521	$2,507
ARM Share (%) g.	38	36	32	33	30	31	30	29	28	26	12	17	19	34	32	28	23
Refinancing Share (%) h.	39	47	45	42	43	42	42	33	32	33	57	59	65	46	43	35	31
Residential Mortgage Debt (%) i.	16.7	11.6	9.2	15.9	15.9	12.3	11.2	13.8	13.6	10.8	10.0	11.8	12.8	13.4	13.3	12.4	10.7

Note: Quarterly and annual forecasts (or estimates) are shown in shaded areas; totals may not add due to rounding; quarterly data expressed as annual rates; annual data are averages of quarterly values.
a. Calculations based on quarterly averages of monthly index levels; index levels based on the seasonally-adjusted, all-urban consumer price index.
b. Quarterly averages of monthly rates (not seasonally-adjusted).
c. Millions of housing units; quarterly averages of monthly, seasonally-adjusted levels (reported at an annual rate).
d. Millions of housing units; total sales are the sum of new and existing single-family homes; quarterly averages of monthly, seasonally-adjusted levels (reported at an annual rate).
e. Annualized growth rate of Freddie Mac's Conventional Mortgage Home Price Index (CHMPI); not seasonally-adjusted.
f. Billions of dollars (not seasonally-adjusted).
g. Federal Housing Finance Board (FHFB); quarterly averages of monthly shares of conventional, home-purchase mortgage closings (not seasonally-adjusted).
h. Primary Mortgage Market Survey; quarterly averages of monthly shares of mortgage applications (not seasonally-adjusted).
i. Federal Reserve Board; growth rate of residential mortgage debt, the sum of single-family and multifamily mortgages (not seasonally-adjusted, annualized rate).

Prepared by Office of the Chief Economist (YC 9/8/2005); Send comments and questions to chief_economist@freddiemac.com.